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Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Proposals to Revise the Methodology for Determining Universal Service Support	)	**CC Docket Nos. 96-45 and 97-160**
	)	
	)	
	)	

REPLY COMMENTS OF MCI

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May 29, 1998

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Executive Summary

Despite the many areas of disagreement among the commentors, and the strong criticism of all the proposals, MCI believes it is possible to focus on the few areas of agreement and critically review the areas of disagreement to construct a framework for an equitable, efficient, and competitively-neutral high cost Universal Service fund for non-rural LECs. Parties agree that:

- Universal Service largely has been achieved. The Act mandates construction of an explicit Universal Service funding mechanism to ensure there will be "sufficient" funding available if and when competition develops that erodes current implicit subsidies in above-cost interstate and intrastate rates.
- The Universal Service subsidy should be defined in terms of affordability. GTE's attempt to define Universal Service in terms of maintaining the current revenue stream of ILECs was rejected by virtually all parties.
- The "above-cost revenues" generated from interstate and intrastate services whose rates are set above cost far exceed the total Universal Service subsidy requirement.
- Because any Universal Service subsidy ultimately must be borne by end users, the Universal Service subsidy should be kept as small as possible while meeting the public policy objective.
- The interstate jurisdiction should, at a minimum, provide support for the highest cost customers, and may be the most efficient source of support for all high cost customers.
- The high cost Universal Service funding mechanisms for rural and non-rural LECs should

be kept separate.

Equity, efficiency, and competitive neutrality require that concurrent with the implementation of an explicit Universal Service subsidy, there must be dollar for dollar reductions in implicit subsidies currently borne by those customers/providers paying into the new explicit fund. Otherwise, the customers and providers paying both implicit and explicit subsidies would be doubly burdened and LECs receiving the subsidies would be doubly paid for providing service.

Universal Service subsidies must be determined in terms of affordability for high cost customers and areas, not in terms of high cost states. Looking at statewide average costs masks the high cost areas that LECs might not be able to serve at affordable rates if competition developed to erode implicit subsidies in above-cost rates for other services.

Universal Service subsidies have historically been funded implicitly from above-cost rates, without distinguishing which interstate and intrastate services were providing the implicit subsidies from those that were simply generating revenues that were needed to recover ILEC inefficiencies, excess profits, and competitive ventures. There is no *a priori* reason for favoring the funding of Universal Service subsidies from the interstate jurisdiction, the intrastate jurisdiction, or some combination of the two. The decision must depend pragmatically on how an equitable, efficient, and competitively-neutral funding mechanism can be constructed. Since some parties have challenged the FCC's legal authority to assess intrastate revenues, limiting the support base to interstate revenues would be the most certain means of implementing a sufficient, explicit, universal service mechanism in a timely fashion.

If the interstate jurisdiction were to properly assume the entire Universal Service subsidy, neither states, ILECs, nor IXCs would be harmed. States would no longer have Universal Service funding responsibility, and would be free to review ILEC proposals for rate rebalancing purely on their merits. ILECs would be compensated for the loss of all implicit subsidies that once funded universal service requirements. And IXCs would not be held harmless if: 1) the fund was limited to social need, 2) implicit interstate subsidies were reduced for every explicit subsidy dollar raised; 3) ILECs were prohibited from recovering the assessment on their retail interstate services from their wholesale customers; and 4) contributors were encouraged to identify the Universal Service assessment on customer bills as a federal high cost Universal Service fee.

Finally, since local competition cannot develop in the absence of deaveraged rates for unbundled loops, the calculation of the Universal Service subsidy should be based on the same level of deaveraging as the state requires for loop rates.

I. Introduction.

The comments filed by more than 30 parties on May 15, 1998, in response to the Commission's request in Public Notice DA 98-175 for comments on various proposals for a high-cost Universal Service fund for non-rural local exchange carriers (LECs), contained more criticism than support for each of the proposals under review. None of the proposals provides a viable foundation on which the Commission can construct an equitable, efficient, and competitively-neutral high-cost fund for non-rural LECs. Nonetheless, the comments provide lively reading and should help spark a spirited debate. MCI believes it is possible to focus on the few areas of general agreement among the parties, and critically review the areas of disagreement to construct a framework for an equitable, efficient, and competitively-neutral fund.

In these reply comments, MCI first identifies several areas of general agreement among the parties and then, while discussing areas of disagreement, lays out a framework for the high cost Universal Service fund for non-rural LECs.

II. There are a number of areas of general agreement.

Despite the many areas of disagreement and strong criticisms of the proposals, there are several important issues about which there is general agreement. First, there is general recognition that Universal Service largely has been achieved. The Commission and the Joint Board have found local rates nationwide are generally affordable and overall subscribership is robust. As Bell Atlantic states,[1]

> the statutory universal service mandate is not the ***achievement*** of universal service, but rather its "preservation and advancement." 47 U.S.C. § 254(b)(4)

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[1] Comments of Bell Atlantic at 2. See also the comments of the Maryland Public Service Commission at 4.

In rewriting the Telecommunications Act, Congress clearly was looking to the future, when competitive market forces might undermine existing implicit sources of Universal Service subsidies. It mandated construction of an explicit universal service funding mechanism to ensure there will be "sufficient"[2] funding available if and when competition develops that erodes current implicit subsidies in above-cost interstate and intrastate rates.[3]

Second, there also is general agreement that the universal service subsidy should be defined in terms of affordability — ensuring that rates remain affordable for consumers who live in high-cost areas.[4] GTE's attempt to define the universal service subsidy as the differential or gap between revenues and forward looking economic cost for all interstate and intrastate services that currently have rates set above cost — in effect, defining Universal Service in terms of maintaining the current revenue stream of incumbent local exchange carriers (ILECs) — was rejected by virtually all parties.[5]

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[2] Section 254(b)(5) mandates "sufficient...mechanisms to preserve and advance universal service."

[3] For several interesting discussions of this, see the comments of the Public Utilities Commission of Ohio at 3, Sprint at 2, Comptel at 2.

[4] See, for example, the comments of TDS Telecommunications Corporation at 2.

[5] See the comments of the Public Utility Commission of Texas at 3-4, the People of the State of California and the Public Utilities Commission of the State of California (hereafter California) at 11, Bell Atlantic at 12-13, Ameritech at 5-6 of Attachment B, Sprint at 6.

Third (and related to this), there is general agreement that not all ILEC revenues generated by above-cost service rates represent universal service subsidies. Indeed, the "above-cost revenues" generated from interstate and intrastate services whose rates are set above cost far exceed the total universal service subsidy requirement.

Fourth, there is general recognition that any Universal Service subsidy must, ultimately, be borne by end users and therefore represents an additional cost imposed on end users. Thus, there is broad agreement[6] that the Universal Service subsidy should be kept as small as possible while meeting the public policy objective.[7]

Fifth, there is general agreement that the interstate jurisdiction should, at a minimum, provide support for the highest-cost customers. In addition, there is wide acknowledgment that the interstate jurisdiction may be the most efficient source of support for all high cost customers.[8] At the same time, there is general agreement that states should be allowed to implement their own explicit, supplemental, Universal Service subsidy mechanisms if they choose to set an affordability

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[6] Virtually every party except GTE, U S West, and BellSouth identified the need to control the size of the Universal Service fund.

[7] There is another important reason why an explicit Universal Service fund should be kept as small as possible. Although it may take some time to occur, implicit subsidies embodied in above-cost rates eventually can be competed away if and when barriers to entry are removed. Therefore, if implicit subsidies are set too high, at least there is some possibility of an eventual market correction. On the other hand, explicit subsidies, once created, are insulated from market forces, and because it is unlikely that there will be significant competitive entry in high cost areas anytime soon, the inflated subsidies will simply go the ILECs, with no benefit to consumers. For that reason, despite all the benefits of explicit subsidies, they can prove harmful if the subsidy calculated and collected exceeds the amount actually needed to meet the public policy objective. Thus, it is especially important that the size of the Universal Service subsidy not be inflated.

[8] See, for example, the comments of Comptel at 3.

benchmark lower than the nationwide benchmark.[9] If they do so, however, they must not impose a state assessment on interstate services or collect state funds from interstate rates or providers.

Finally, there is wide scale agreement that the high cost Universal Service funding mechanisms for rural and non-rural LECs should be kept separate.[10] The Ad Hoc proposal to combine the rural and non-rural high cost funds was almost universally rejected.

III. Equity, efficiency, and competitive neutrality require that concurrent with the implementation of an explicit Universal Service subsidy, there must be dollar for dollar reductions in implicit subsidies currently borne by the customers/providers paying into the new explicit fund.

Since the net revenues generated from interstate and intrastate services whose rates are set above cost far exceed the revenues needed for Universal Service support, and since competition has not yet developed to erode those above-cost rates, no party questions that it is possible to implement a sufficient explicit subsidy and reduce above-cost rates dollar for dollar. If the dollar for dollar reductions are not made, however, so that an additional subsidy is created without a decrease in existing implicit subsidies, then customers and providers paying these implicit and explicit subsidies would be doubly burdened and LECs receiving the subsidies would be doubly paid for providing service. This would have perverse equity, efficiency, and competitive impacts, as one set of customers and providers would be facing unjustified increases in costs while ILECs would enjoy an unjustified increase in revenues.[11]

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[9] See, for example, the comments of Sprint at 2.

[10] See the comments of every party representing rural telephone companies.

[11] Since there is likely to be very limited competition in rural areas for the next several years, ILECs would get virtually all the new explicit subsidy funds and also would continue to receive the implicit subsidies.

Moreover, it is not sufficient simply to decrease any above-cost rates when a new explicit subsidy is implemented. There must be dollar for dollar reductions in the implicit subsidies **currently borne by the customers/providers who pay into the new explicit fund**. Otherwise, there still will be a double burden imposed on those customers/providers who now pay into the explicit fund who are still paying implicit subsidies through above-cost rates for services.

Proposals, such as the Ad Hoc proposal, to assess interstate customers/providers for an explicit fund and then reduce intrastate rates must be rejected outright as they would inequitably and inefficiently impose burdens on interstate customers and providers and would undermine competitive neutrality by double-billing interstate providers. Section 254(b)(4) of the Act requires the Commission to base its Universal Service policies on the principle that all telecommunications service providers make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service. It would be discriminatory if the Commission did not reduce implicit interstate subsidies for every additional explicit interstate subsidy dollar raised, since this would impose a double burden on interstate providers and their customers and would give non-rural LECs double recovery of some costs.[12]

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[12]Moreover, once implicit universal service subsidies have been replaced by the explicit fund, there will no longer remain any justification for retaining the remaining subsidies, since doing so would sustain inefficient and anticompetitive pricing practices. Thus, the Commission should immediately reduce access rates to economic cost once an explicit subsidy fund has been established.

IV. Universal Service subsidies must be determined in terms of affordability for high cost customers and areas, not in terms of high cost states.

Some states became concerned about the sufficiency of the new fund as it was initially set up by the FCC because (1) the FCC accidentally imposed a rule change that had the effect of shifting $300 million in revenues from the intrastate to the interstate jurisdiction at the same time that it announced that it would provide only 25 percent of the universal service subsidy funding, and (2) NARUC's Ad Hoc group distributed misleading and inflammatory information about the impact of these changes by performing impact calculations that included the rural as well as non-rural LECs despite the fact that the FCC proposal explicitly excluded the rural LECs.

The confusion created led several states to move away from the concept of affordability for high cost users or areas when calculating the Universal Service subsidy and turn instead to a relative cost benchmark that was an attempt to measure the ability of "high cost states" (or, more exactly, "high average cost states") to support Universal Service on their own.[13] For example, rather than calculating the universal service subsidy by comparing the cost of providing service to a specific customer to an affordability benchmark, Ad Hoc proposed comparing nation-wide average costs to state-wide average costs. Virtually all parties[14] — including state public utility commissions and a BOC — criticized that approach as inappropriate and unnecessary.

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[13] See the joint comments of the Maine Public Utilities Commission, the Vermont Public Service Board, the South Carolina Public Service Commission, the Arkansas Public Service Commission, the West Virginia Public Service Commission, the New Hampshire Public Utilities Commission, and the New Mexico State Corporation Commission (hereafter referred to as Maine, et.al.).

[14] See, for example the comments of the Public Utilities Commission of Ohio at 3-5, the Public Utility Commission of Texas at 4, Ameritech at Attachment B, AT&T at 14-15, Comptel at 4.

There are a number of problems with the "high average cost state" approach to funding Universal Service. First, using a benchmark based on statewide average cost masks the high cost areas that LECs might not be able to serve at affordable rates if competition developed to erode implicit subsidies in above-cost rates for other services. Second, by looking at state averages, the focus turns from identifying the actual explicit subsidy needed to an investigation of whether a state's overall cost structure is able to produce implicit subsidies from low-cost areas. Thus, it is inconsistent with the Act's directive to create explicit subsidies as the alternative to implicit subsidies. Third, using a cost, rather than an affordability benchmark prevents one from calculating the minimum subsidy needed to make basic telephone service affordable.

In addition, by moving from an objective measure of Universal Service need (comparing forward-looking economic costs to an affordability benchmark) to a subjective measure of what represents a high cost state, incentives and opportunities are created for states and LECs to game the selection of cost measures and subsidy calculations. It is noteworthy that the State of New York Department of Public Service claims "New York is a 'high cost' state,"[15] and strongly supports the Ad Hoc "high average cost state" proposal while Maryland Public Service Commission, following common sense, identifies New York as a "low cost" state and notes that New York fares much better than Maryland does under the amorphous "high average cost state" mechanism constructed by Ad Hoc.[16] It would be much more equitable to calculate Universal Service subsidies based on the proper definition. This would result in a flow of funds to Bell Atlantic as a non-rural LEC to the extent it serves truly high cost areas in New York such as the

[15] Comments of the State of New York Department of Public Service at 2.

[16] Comments of the Maryland Public Service Commission at footnote 2.

Adirondacks, but not in a general flow of funds to subsidize Bell Atlantic for its merger with New York Telephone Company that somehow has higher than average embedded costs despite serving a primarily urban customer base.[17] Not surprisingly, in its comments, Bell Atlantic argues that "federal support should be targeted to high cost *states*"[18] and supports using the Ad Hoc approach, but proposes restricting the use of forward-looking economic costs to calculate the subsidies.[19] Thus, it would use a "high cost state" funding mechanism to impose on interstate customers and providers throughout the United States the embedded costs associated with its inefficient NYNEX operations. The Maryland Public Service Commission correctly points out that imposing such costs on the customers in other states makes it more difficult for those others states to meet their own "specific Universal Service funding needs."[20]

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[17] Interestingly, Maine et.al., in their comments at 5, propose expanding Universal Service support to high cost trunking facilities, noting that the national average embedded trunking cost is $41.50 per line per year, but in New York and Massachusetts average trunking cost approaches $80. Given scale and scope economies in trunking, the embedded trunking costs for New York and Massachusetts must include huge cost inefficiencies that should not be borne by providers and customers in other states who contribute to a high cost Universal Service fund.

[18] Comments of Bell Atlantic at 3; emphasis in the original.

[19] Comments of Bell Atlantic at 6.

[20] Comments of the Maryland Public Service Commission at 5.

V. There is no *a priori* reason for favoring the funding of Universal Service subsidies from the interstate jurisdiction, the intrastate jurisdiction, or some combination of the two. The decision must depend pragmatically on how an equitable, efficient, and competitively-neutral funding mechanism can be constructed.

Since the Universal Service subsidy has been funded implicitly from above-cost rates, there has never been an explicit identification of which interstate and intrastate services were providing the implicit subsidies and which were simply generating revenues that were needed to recover ILEC costs associated with inefficiency, failed ventures, cross-subsidization of competitive ventures, excess ILEC profits. Historically, the ILECs have taken advantage of this situation, arguing in each jurisdiction that the above-cost rates in that jurisdiction were needed to support Universal Service. Therefore, there is no *a priori* guidance on which service rates (interstate, intrastate, or a combination of the two) should be reduced.[21]

From the perspective of meeting the universal service objective of ensuring affordability, there is no difference whether the explicit subsidy (and reduction in implicit subsidies) is borne by the interstate or intrastate jurisdictions, or shared by the two. From the perspectives of efficiency, equity, and competitive neutrality, the issue is ***how*** an interstate or intrastate or mixed fund is constructed, not whether it is an interstate, intrastate, or mixed fund.

If there is reason to believe that the implementation of an explicit Universal Service fund is less likely to be accompanied by a dollar for dollar decrease in above-cost rates for the contributors to the explicit fund in the intrastate jurisdiction than in the interstate jurisdiction, then good public policy dictates going with an interstate fund — and vice versa. The clear language of

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[21] It is not clear on what basis Chairman Kennard includes as one of his principles that Universal Service subsidies should be provided principally from the intrastate jurisdiction. As explained below, if properly structured, funding can come from the interstate jurisdiction without detriment to equity, efficiency, or competition.

Section 254(b)(4) authorizes the Commission to include interstate and intrastate revenues to calculate each carrier's share of support, as well as to assess both interstate and intrastate revenues to fund universal service support.[22] However, since some parties have challenged the FCC's legal authority to assess intrastate revenues, limiting the support base to interstate revenues would be the most certain means of implementing a sufficient, explicit, universal service mechanism in a timely fashion.

There is one other public policy reason for considering an interstate-only fund. Although ILEC rates are regulated by the FCC (interstate) and the state commissions (intrastate), the ILECs enjoy great discretion in setting rates — and, in particular, in initiating rate changes. Despite their very high profit rates, the large non-rural ILECs rarely propose rate decreases unless they are under significant competitive pressure or hope to pre-empt competitive entry by strategically reducing certain rates. This is evidenced by the failure of interstate access charges to come down after the Commission's decision to leave reductions to market pressure, rather than Commission directive. If regulators want to see rates fall, so customers can benefit, then they should remove the implicit subsidies in above-cost rates that are not subject to competition before they do so for services that are beginning to face competition. This would argue for implementing an explicit interstate fund, with concurrent reductions in interstate access charges, rather than implementing an intrastate fund with concurrent reductions in rates for local business or CLASS services. The latter will come down on their own more quickly than access charges.

[22] "All providers of telecommunications services should make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service."

VI. An explicit interstate fund with dollar for dollar decreases in interstate access charges does not harm any state or ILEC.

If the interstate jurisdiction were to assume the entire Universal Service subsidy under a nationwide affordability benchmark, with a concurrent dollar for dollar reduction in interstate access charges, states and ILECs would not be harmed. States would no longer have any Universal Service funding responsibility (unless they chose to supplement the nationwide affordability benchmark with a lower benchmark of their own). Ad Hoc has alleged that some states could face a problem if sometime in the future competition were to drive the rates for intrastate services that currently are set above cost down to cost, but if the interstate jurisdiction is fully funding the Universal Service subsidy through an explicit mechanism, there would be no need to maintain the above-cost intrastate rates for Universal Service purposes.

Claims that an interstate-only fund with concurrent reductions in interstate access rates would harm states or ILECs are based on the false assumption that current intrastate revenue levels must be guaranteed. In fact, by removing Universal Service funding responsibilities from the states (except to the extent states choose to set an affordability benchmark that is lower than the nationwide benchmark), creating an interstate fund with concurrent reductions in interstate access charges would free the states to review ILEC proposals for rate rebalancing purely on their merits, without having to address murky questions about the impact on Universal Service.

VII. If properly constructed, an interstate Universal Service fund would not harm providers that are primarily interstate carriers.

Interexchange carriers (IXCs), as the primary providers of interstate services, would not be harmed competitively if an explicit all-interstate Universal Service funding mechanism were implemented with the following components:

- There is a dollar for dollar decrease in implicit interstate subsidies[23] so interstate providers/customers are not double assessed.
- The size of the fund is carefully calculated to ensure it is not inflated. Otherwise, some above-cost interstate access charges that could eventually be competed away would be insulated from competitive erosion. Since there is unlikely to be a lot of competitive entry anytime soon into the rural geographic areas currently served by non-rural LECs, all the inflated subsidy funds would simply go to the non-rural ILECs.
- The LECs are prohibited from recovering the assessment on their retail interstate services[24] from their wholesale customers (the IXCs), through the inclusion of these costs in access charges or through any other method. Otherwise, the IXCs will be doubly burdened.[25]

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[23] Accomplished in the following order: (1) pay off the additional interstate revenue requirement allocation made under Rule 36.631; (2) reduce interstate access charges, starting with the CCLC, then, if needed, the PICC, and then, if needed, the local switching charge.

[24] LEC retail interstate revenues are generated by subscriber line charges (SLC), on special access services provided to end users, the full array of retail interstate services provided by non-BOC non-rural carriers, and those retail interstate services that the BOCs have received waivers to provide. In its comments, California (at 13) explicitly states that the assessment should be made on the SLC revenues.

[25] See the comments of Sprint at 5 for an informative discussion of this concern.

- All contributors are encouraged to identify the Universal Service assessment on customer bills as a federal non-rural high cost Universal Service fee. One way to do this is to allow the subsidy to be collected as a percentage charge on each interstate customer's retail charges.[26]
- Prohibit any funding of explicit state universal service funds from being imposed on interstate services or collected from interstate rates or providers. Otherwise, interstate providers and customers will be double burdened.

VIII. Since local competition cannot develop in the absence of deaveraged rates for unbundled loops, the calculation of the Universal Service subsidy should be based on the same level of deaveraging as the state requires for loop rates.

In the Act, Congress sought to construct an explicit Universal Service funding mechanism to ensure there will be "sufficient" funding available if and when competition develops that erodes current implicit subsidies in above-cost interstate and intrastate rates. Where unbundled loop rates are not deaveraged at all, or are not deaveraged enough to reflect underlying costs, competition cannot develop that would erode the implicit subsidies. Sufficient Universal Service funding will be available as long as the subsidy calculation is based on the same degree of disaggregation/deaveraging as the state uses in setting the unbundled loop rates. Moreover, if Universal Service funding is calculated on a more disaggregated/deaveraged basis than used for setting rates for unbundled loops, there will be a discrepancy between the costs faced by CLECs and the Universal Service funding available to them, with the result that CLECs would receive too little Universal Service funding when providing service in moderately high cost areas, but unable

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[26] A number of parties propose a specific line item on end-user bills. See the comments of AT&T (which references paragraph 229 of the FCC Report to Congress) at 19, California at 3.

to receive additional support in very high cost areas because the Commission has limited CLEC subsidy receipts to the difference between the cost of unbundled elements and the benchmark rate. The absence of loop rate deaveraging will effectively limit both competition, and an equitable distribution of subsidies among carriers. Therefore, the Universal Service subsidy should be calculated in the following fashion:

- For each carrier, calculate the size of the interstate subsidy by comparing the affordability benchmark to the forward-looking economic cost of providing service, calculated using the same cost zones as the state uses for setting deaveraged loop rates.[27]

IX. The Universal Service funding mechanism must not favor incumbent LECs or give the states the discretion to distribute funds in a fashion that does not strictly mirror cost zones.

In its comments, the Association for Local Telecommunications Services (ALTS) identifies additional defects in the Ad Hoc proposal that must be avoided in any Universal Service funding mechanism:

> First, the plan seeks to guarantee to the incumbent local exchange carriers certain amounts of support regardless of the cost of provision of service. While the Act clearly seeks to ensure service at reasonable prices in high-cost areas, it should not be read as any kind of an income guarantee for carriers in high cost areas. Second, the preference given to incumbent local exchange carriers in the receipt of Universal Service support is anticompetitive....[28]

MCI fully agrees with ALTS that the distribution of Universal Service funds must not be abused to guarantee revenues to any LEC or to discriminate in favor of ILECs or against CLECs..

In its comments, Sprint raises valid concerns about giving the state commissions total

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[27] Comptel makes the same proposal. See the comments of Comptel at 5.

[28] Comments of ALTS at 4.

discretion on how to distribute the subsidy dollars in the explicit subsidy fund:

> Because the size of the fund will be decided on a [geographic cost zone] basis, logic and fairness dictate that the contents of the fund be distributed on that basis as well. A state must not be permitted to secure universal service funds associated with a high cost [zone] and then redirect those monies to unrelated subscribers or services. Similarly, the tenets of competitive neutrality require new entrants to receive the same number of universal service dollars as an ILEC would for serving the same customer.

MCI agrees with Sprint that the distribution of the explicit subsidy funds must directly reflect the subsidy calculations performed and must be "portable," that is, available to whoever is providing service to the high cost customer.

X. The Commission should not grant additional exemptions from its rules to rural carriers.

A number of rural carriers question whether a forward-looking economic cost proxy model can ever capture their unique cost features.[29] They argue that the transition to forward-looking subsidy mechanisms would be inaccurate and disruptive. On this basis, they request the Commission permanently exempt them from having their Universal Service support calculated according to the difference between a national benchmark price and a their forward-looking cost. MCI disagrees with their allegations, which are not based on fact, and strongly opposes this request. Considerable progress has been made in the accurate modeling of rural carrier costs, and MCI believes that proxy models provide more accurate market signals than reliance on embedded monopoly costs. Permanently exempting rural carriers from the benchmark/proxy cost approach for rural carriers would be tantamount to rejecting the proper approach to determining the Universal Service subsidy. At a minimum, it would be premature for the Commission to consider

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[29] See, e.g., Comments of USTA at 4; Western Alliance at 3; Small Western LECs at 7; ITC at 2; RTC at 12.

this request before completing its rural modeling investigation.[30]

XI. The Commission should rely on temporary waivers of its rules to correct anomalies in the transition to a forward-looking subsidy mechanism for non-rural carriers.

Puerto Rico Telephone Company (PRTC) is alone among the non-rural carriers seeking to be exempted from forward-looking subsidy calculations until proxy cost models yield subsidies at levels equal to existing subsidy mechanisms.[31] PRTC notes that in 1997 it received over $107 million in receipts from the high cost and long term support programs.[32] Since, its high cost support amounted to approximately $27 million in 1997, its LTS support was about $80 million. PRTC estimates that it will receive $146 million from high cost and long term support in 1998 — a 36 percent increase.[33] Since one-fourth of the HAI subsidy estimate of PRTC would be $0.4 million, PRTC stands to lose nearly all its existing support in 1999. On an intrastate revenue base of $940 million, PRTC would have to raise intrastate rates by 15 percent in order to maintain its

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[30] MCI also rejects rural carrier requests for the Commission to reconsider its transition rules pertaining to rural carriers in this docket. This docket has been limited to issues affecting the subsidies received by non-rural carriers: "...prior to implementing the Commission's methodology for determining high cost support for non-rural carriers, the Commission will complete a reconsideration of its 25/75 decision and of the method of distributing high cost support." Common Carrier Bureau Seeks Comment On Proposals to Revise the Methodology for Determining Universal Service Support, CC Docket Nos. 96-45 and 97-160; DA 98-715; Released April 15, 1998, at 1.

[31] PRTC Comments at 7.

[32] Proposal of PRTC at 6.

[33] PRTC estimates it will receive $96 million in LTS and $49 million in HCF in 1998. See Federal Universal Service Programs Fund Size Projections and Contribution Base for First Quarter 1998, Universal Service Administrative Company, (*USAC Filing*) October, 31, 1997.

revenue stream.

MCI is concerned that such an increase in rates could harm affordability, but is not convinced that all of this subsidy payment is needed to preserve and advance Universal Service in Puerto Rico. One part of the problem appears to be PRTC's receipt of long term support, which unlike the high cost fund, does not assume larger companies are more efficient, and therefore deserving of smaller subsidies. PRTC, with 1.2 million USF loops, has four times as many loops as the next largest company receiving LTS.[34] PRTC accounts for 13 percent of loops of the companies that receive LTS, and receives 20 percent of the LTS subsidy. One would normally expect economies of scale to operate, so that even if PRTC was operating in high cost conditions, it would receive a smaller share of LTS receipts than its share of LTS loops. The opposite is the case, suggesting diseconomies of scale — i.e., inefficient operations. According to PRTC's competitors, PRTC, which has been a state-owned entity, has not been price- or cost-regulated, and its current regulatory review board "...is prohibited by law from adopting any rate regulations."[35] It is not surprising that an unregulated monopoly has demonstrated such inefficient performance. The issue is how to implement a transition plan that will not create rate shock, but also will force PRTC to become more efficient. It is noteworthy, in this regard, that it was announced this week that GTE will acquire a controlling stake in PRTC for $375 million.

To avoid rate shock, MCI supports granting PRTC a one-year exemption from being considered a non-rural carrier. Although GTE might merit a one year exemption to allow for a

[34] C-TEC, with 240,000 loops, is the next largest company receiving LTS See, USAC filing.

[35] Celpage at 5.

transition from state ownership, the exemption should not exceed one year. This should give the Commission time to choose a forward- looking model for non-rural carriers, and make any modifications necessary to account for PRTC's unique situation. Given the lack of prior cost or price regulation, a forward-looking cost model is likely to provide the most accurate assessment of legitimate Universal Service subsidy requirements in Puerto Rico. MCI strongly opposes waiting any longer before applying some cost oversight to PRTC's subsidy receipts. Since the Commission is not authorized to set cost-based rates for PRTC, as suggested by Celpage, applying a proxy cost estimate of legitimate Universal Service subsidies is the most appropriate method for establishing some oversight of PRTC's subsidy receipts. This one year exemption also should give PRTC time to convince its Regulatory Board to submit a Puerto Rico proxy cost model if it is concerned the Commission's forward-looking cost model will not accurately estimate its subsidy requirements.

XII. Conclusion

For the above-mentioned reasons, MCI encourages the Commission to adopt the proposals and recommendations made by MCI in these Reply Comments.

Respectfully submitted,
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May 29, 1998

Statement of Verification

I have read the foregoing and, to the best of my knowledge, information and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on May 29, 1998.

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Service List

I, Barbara Nowlin, do hereby certify that a copy of the foregoing **Reply Comments** has been sent by United States first class mail, postage prepaid, hand delivery, to the following parties on this 29th May, 1998.

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